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Weekly Equities Commentary

13 Sep 2021

Equities stumble, but we see reasons for optimism

Labor Day week wound up being laborious for equities, as the wall of worry proved too difficult to climb. Concerns about a looming Fed taper, a complicated path for stimulus and debt ceiling negotiations and ongoing worries about the Delta variant drove the S&P 500 (-1.7%), DJIA (-2.4%) and Nasdaq (-1.4%) to finish in the red. The U.S. Treasury curve steepened, and the 10-year yield held above 1.30%.

KEY POINTS

- **Despite elevated risks, we remain optimistic toward economic growth and equity markets.**
- **The European Central Bank (ECB) announced it will moderately slow the pace of its bond purchases, but our timeline for the Fed taper has not changed.**
- **Cost pressures and ongoing supply chain constraints have fueled talk of stagflation, which we believe is unlikely.**
- **China's regulatory changes remain a risk, but our sentiment on Chinese equities improved last week following several government actions.**

Saira Malik, CFA
CIO of Nuveen Equities

Saira Malik oversees the equities strategic direction for Nuveen as chair of the Equities Investment Council (EIC) and a member of Nuveen's Global Investment Committee (GIC). She has responsibility for equity portfolio management, equity research, equity trading, target date, quantitative and index strategies, as well as portfolio management responsibilities for global equity strategies.

Market drivers & risks

- **The Fed is unlikely to make a policy mistake.** In our view, it is still appropriate for QE tapering to start later this year, or in the beginning of 2022.
  - Earlier this year, markets were concerned that a potentially overheating economy and powerful reopening momentum would accelerate the tapering timeline. Those concerns have now abated given some weaker economic data, such as August nonfarm payrolls. The recent climb in the 10-year Treasury yield indicates that markets are functioning well. Although the Delta variant, debt ceiling uncertainty and even September's historically poor seasonality may drive bouts of volatility, we anticipate strength in manufacturing, payrolls and consumer confidence.
- **There will soon be less "PEPP" in the ECB's step.** The central bank will slow the pace of its Pandemic Emergency Purchase Programme (PEPP), which should be a small but meaningful start to unwinding emergency aid.
  - Last Thursday's announcement reflects a eurozone economy that is now on stronger footing and can maintain favorable financing conditions as the tapering of asset purchases begins. The ECB's move also comes after eurozone inflation increased to a 10-year high of 3% year-over-year in August. The interest rate on the main refinancing operations was not changed from its record-low level (-0.50%). Importantly, unlike the Fed, the ECB does not consider the labor market to be part of its mandate, and the PEPP decision does not alter our views regarding the start of Fed tapering.
- **U.S. stagflation concerns should pass,** as conditions leading to price spikes remain transitory.
  - Last Friday's release of the producer price index for August showed a year-over-year 8.3% increase. Producer prices and other inflation readings have risen in recent months, prompting talk of stagflation. While COVID-19 has constrained supply chains, we continue to believe these imbalances – and the resulting inflationary pressures – will run their course. Inflation expectations, as measured by the 5- and 10-year breakeven inflation rates, have actually decreased since the April 2021 Consumer Price Index report. Ultimately, we think economic growth can be sustained above long-term averages and that inflation will settle at approximately 2.5% over the next several years. This outlook supports our view that equity markets will add modestly to their gains during the remainder of this year.

> ***"While we understand the reasons for recent concerns, we remain generally optimistic regarding further economic growth and continue to see upside potential in equities."***

Highlights from last week

- Each of the 11 GICS sectors posted losses. Real estate (-4.0%) and health care (-2.7%) finished at the bottom of the pack, after topping the list the week before. Industrials (-2.5%) were close behind. Cyclical sectors (-1.5%) outperformed defensives (-2.4%) as the Treasury curve steepened modestly. Large caps (-1.8%) held up better than small caps (-3.3%), while growth (-1.2%) beat value (-2.4%).
- In Japan, equities rallied in the wake of Prime Minister Yoshihidi Suga's resignation announcement, with the TOPIX (+2.8%) reaching a three-decade high. Hong Kong's Hang Seng Index (+1.5%) gained in part due to assurances from Beijing that the government was committed to further developing China's private sector.

Risks to our outlook

The Delta variant could slow economic growth in several ways, but our primary concern centers on companies providing updates on continuing cost pressures and supply chain constraints.

Because factions within the Democratic caucus have delayed progress on the Biden administration's stimulus push, markets have yet to assess or react to the increases in corporate and capital gains taxes that would accompany passage of the federal spending package.

As we saw last week, equity markets are susceptible to pullbacks. Weak economic data, valuations that are considered too high or overextended investment sentiment all have the potential to spark negative market reactions.

Despite these risks, the global economy and equity market fundamentals remain strong, and we remain confident in the market's ultimate ability to climb the wall of worry.

Best ideas

An environment of stronger relative earnings growth and attractive valuations in developed non-U.S. markets, particularly in Europe, could be a catalyst for outperformance by select stocks in cyclically oriented sectors. We remain broadly bullish on emerging markets, but are guarded with respect to Chinese equities. Near term in the U.S., we see opportunities in defensive sectors and structural growth stocks during this period of soft economic data, but continue to favor a long-term approach that balances these exposures with cyclicals and value.

In focus

Financials: solid opportunities, but selectivity is key

Bank stocks are up nearly 30% year to date, outperforming the broad S&P 500 Index by more than 10%. This strong relative performance can be attributed to an improving U.S. economy, higher interest rates, increased capital return, strong (and better-than-expected) credit quality and an inexpensive starting point for valuations.

Banks are now trading well off their 2021 peaks, however, as the 10-year U.S. Treasury yield has retreated from its March highs and reflation expectations have cooled. Current valuations appear fair, and fundamentals are mixed, with the 10-year yield hovering around 1.3% and soft loan growth making it more challenging to reach net interest income expectations.

We believe loan growth is being held back by supply-side disruptions, the roll-off of small-business Paycheck Protection Program (PPP) lending, economic uncertainty and diminished demand for credit due to flush corporate and consumer balance sheets. We don't expect these factors to be obstacles as we head into 2022.

Today's market environment for banks and other financial services industries should create opportunities for bottom-up stock pickers. Among the ideas we favor are regional banks with strong expense controls leading to better operating leverage, select credit card names that are less dependent on interest rates and financial companies returning above-average levels of capital to investors via dividends and share buybacks.

About the Equities Investment Council:

The Nuveen Equities Investment Council (EIC) includes the firm's senior equity portfolio managers, averaging three decades of investing experience. The EIC brings global expertise across different styles of equity investing and provides value-added insights to Nuveen's investment process by refining and delivering the firm's collective equity market outlook, including key risks and drivers, to clients. Led by Saira Malik, CIO & Head of Equities, the team shares best global equities ideas, while focusing on individual areas of expertise to help generate alpha.

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Sources

All market data from Bloomberg, Morningstar and FactSet.

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